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Long Run Health Care Cost Growth

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The rapidly rising cost of health care is one element of the current fiscal difficulties facing state government. This paper examines the problem from the historical perspective and clarifies the nature of the problem. It also examines key trends that will affect the near future.

Background Sources

The National Health Statistics Group, Office of the Actuary, Health Care Financing Administration (Now The Center for Medicare and Medicaid Services) provides the most authoritative and comprehensive reporting of historical data and forecasts for health care expenditures. Their most recent forecast is described in "Health Spending Growth Up In 1999; Faster Growth Expected In The Future" in the March/April 2001 edition of *Health Affairs*. They project that overall health care spending will grow at an annual average rate of 7.2 percent per year between 1998 and 2010. They also note that health care spending was 10.9 percent of GDP in 1988 and will rise to 15.9 percent of GDP by 2010.

DRI-WEFA, the firm that provides the national economic forecasts on which the state revenue forecast is based, also tracks and forecasts health care spending. The attached graph displays the history and projection of real, per capita medical services consumption from 1967 through 2011. In the historical period, which ends in the first quarter of 2001, this variable has grown from $1,350 per year to $3,900 per year. Both of these figures are stated in 1996 dollars after adjusting for inflation. This amounts to an annual inflation-adjusted growth of about $63 per year. The graph is useful in putting recent history into a historical context. There is a burst of increasing growth above the long-term trend rate leading up to the early nineties. This is followed by a brief deceleration, a period of increasing growth, and then a return to the historical rate of growth. Growth after 2001 is projected to be above the long-term rate. The cost level is predicted to return to the level predicted by the long-term trend line by 2005.

In a comparative study of advanced countries conducted by the **Commonwealth Fund**, available at http://www.cmwf.org/programs/international/ the following facts were noted:

- **The Level of Spending on health care in the US is exceptionally high.** In 1997, per capita spending on all health care services ranged from a high of $4,090 in the United States to a low of $1,347 in the United Kingdom. The median for all 29 OECD countries was $1,747. The United States was the clear outlier: its per capita health care expenditures were more than double the OECD median and 75 percent greater than Germany's, the country with the second highest level of per capita expenditures. All expenditures were adjusted to U.S. dollars using purchasing power parities, a common method of adjusting for cost-of-living differences.

- **The rate of growth of spending on health care in the US is similar to that of other countries**. While per capita health care expenditures were much higher in the United States, the annual rate of increase from 1960 to 1997 was similar to that of the OECD median. In the United States, spending increased at an average annual rate of 9.4 percent from 1960 to 1997 compared with 9.2 percent in the median OECD country. The country with the most rapid average annual rate of increase during this period was Japan (12.0 percent), and New Zealand had the smallest increase (7.5 percent).

Conclusions From the Background Material

The point to be drawn from these studies is that the exceptional rate of growth in health care costs relative to other categories of private and public spending is not unusual. The exceptional period in the United States was the period of slow growth in the middle portion of the nineties. Medical cost growth is now returning to what has been normal in most advanced countries for at least the last forty years.

Explanation

Why do health care expenditures grow faster than other categories of spending? A large part of the answer lies in the fact that health care changes in its very nature as time passes. The consumers of 2001 purchase a set of health related goods and services that are very different from those purchased by the consumers of 1967. Technological progress has provided cures, available in 2001, which could not have been purchased in 1967 at any price. As these new services have been made available, society decided that this category of consumption should expand at the expense of others. There is another question, which would be much more difficult to answer: How much would it cost in 2001 to provide the health care services which were typically purchased in 1967? It is important to realize that this is not the question being answered when the statistics described above are produced.

Part of the confusion comes from the real meaning of the phrase "society decided." It may be useful to think about similar events in a pre-historical setting. Imagine a simple band of hunter-gatherers. They devote most of their available time to gathering food, shaping rocks and sticks into tools, etc. Recently the band became aware of the healing properties of the bark of a certain tree. They have consciously altered their behavior and now spend some time gathering the bark. This means that there is less time available for the other work. . They understand clearly that they will have less in the way of food, tools, etc. but they want the bark enough that they think the tradeoff is wise. Modern society makes choices like this, but the elemental reality of the implied sacrifices of other goods is obscured by our institutional agreements.

Progress happens and the health plan is contractually required to provide what is "medically necessary." Health plans transmit the costs of the expanded scope of medically necessary care to employers, etc through increased rates. Employers and other third party payers write the contracts with the health plans and see the rising cost of the coverage as a troublesome obligation created by their relationships with the ultimate consumers. The real cost of the progress is obscured by the third party payment system.

Contrast this with the impact of progress in the area of consumer electronics. Any tracking of the share of consumer expenditures going to electronic equipment of the last fifty years would certainly show that this category of expenditure has grown remarkably. Anyone alive in the late forties can remember the single console radio in the living room. This has been replaced by multiple color televisions, cable service, VCR's, CD players, high quality stereo systems, personal computers, printers, scanners, etc. The comparable figures in this reallocation of consumption have raised little attention or concern. These decisions resemble the decisions made by primitive men to spend a little more time gathering bark and therefore have fewer berries. Our institutional arrangements with respect to health care cause us to see progress as a problem.

There are two good references on the changing nature of health care and its implications for measurement of health care expenditures.

The first is an article "Medical Care Costs: How Much Welfare Loss?" by Joseph Newhouse, in the *Journal of Economic Perspectives*, Summer 1992.

The second is a book edited by Jack Triplett, *Measuring the Prices of Medical Treatments*, Brookings Institutions Press, 1999. This is a collection of papers presented at a conference jointly hosted by Brookings and the American Enterprise Institute.

The Near Future

There are two widely recognized trends, which suggest that in the near future, medical costs will grow more rapidly than they have for the last forty years.

The first trend is the increasing rate of technological progress in the biomedical area. This is impossible to quantify but extremely obvious. The human genome has been mapped and this knowledge may lead to genetic treatments for many conditions. Pharmaceutical research is moving from blind search to conscious design based on other progress. Clones of mammals have been produced, opening up another potential direction for progress. The list of recent significant breakthroughs is lengthy. The subsequent development of commercial products will follow. These commercial products will almost all exist as private property protected by patent law. The cost to consumers of these products will be subject to monopolistic pricing. When these new treatments become established as normal medical practice they will automatically be brought into the scope of services covered as medically necessary under standard health insurance contracts. Moreover, insurers, unaware of the exact timing of these events, will protect themselves from financial ruin by adding an additional risk premium to the cost of coverage. The increasing rate of technological progress, which we all look forward to, is one of the key components of future health care cost growth.

The second trend is the aging of the population as the baby boom generation passes into later middle age and then retirement. The table below shows how key age groups will change during the next ten years in Washington State.

Washington State Population from 2000 - 2010							
Year ==>	2000	2005	00-05 change		2010	00-10 change	
Age Groups:			Total	Annualized		Total	Annualized
All	5,894,121	6,263,937	6.27%	1.22%	6,696,055	13.61%	1.28%
0-19	1,683,019	1,719,999	2.20%	0.44%	1,778,246	5.66%	0.55%
20-64	3,548,954	3,837,407	8.13%	1.58%	4,110,197	15.81%	1.48%
50-64	888,329	1,116,393	25.67%	4.68%	1,320,064	48.60%	4.04%
65+	662,148	706,531	6.70%	1.31%	807,612	21.97%	2.01%
85+	84,085	102,122	21.45%	3.96%	120,656	43.49%	3.68%

Implications for the Public and Private Sector

This analysis has major implications for the cost pressures faced by both business and government. In the case of government, trends in health care costs are already causing other programs and services to compete for scarce dollars with government funded health care insurance. This situation has already affected the composition of the 2001-03 Biennial Budget for Washington and other states, and is likely to affect budget deliberations for the foreseeable future. For the private sector, rising health insurance costs are causing overall employer costs to rise. When the cost of health benefits increases, employers usually look to reduce growth in other forms of compensation, such as wages. Both government and private sector employers are also increasingly requiring employees to pay higher shares of premium costs or to assume higher co-payments. These trends are also likely to continue for the foreseeable future.

Inflation-Adjusted Medical Services Per Capita